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CPA

Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

January 2017

Be Cautious With Hard-to-Value IRAs

A new year begins with celebrations, resolutions, and dual IRA opportunities. Most workers and their spouses have until April 18, 2017 (April 19 in some states), to contribute to an IRA for 2016. At the same time, contributions to 2017 IRAs are now permitted; the earlier money goes into the account, the more time for tax-deferred investment buildup.

While you consider IRA contributions, you should also take this time to review IRA investments. Virtually any investment can go into an IRA, other than life insurance and collectibles. In recent years, questionable outlooks for stocks, bonds, and savings accounts have encouraged many IRA owners to consider—or put money into—nontraditional IRA assets.

Assessing alternatives

Consequently, IRA owners can invest in real estate, venture capital pools, even their nephew's Internet startup that hopefully will become the next Google. Such outlays may or may not prove to be good uses for retirement funds. In any case, however, some tax-related issues will arise.

IRAs must be valued for certain purposes, and illiquid assets are not as easy to value as listed securities or mainstream savings instruments. The IRS, which views undervaluation as a potential problem, has made some changes in reporting requirements, in order to spotlight alleged transgressions. IRA owners face painful consequences if they trigger IRS displeasure in this area.

Lower value, less tax

IRAs need to be valued for purposes such as required minimum distributions (RMDs) and Roth IRA conversions.

Example 1: Bill Carson, an experienced real estate investor, has most of his traditional IRA money in private real estate partnerships. Now that he is past age 70½, Bill must take RMDs from his IRA each year and pay tax on the distributions. The lower the value of the real estate, the less tax Bill will pay on his RMDs.

There is no readily visible market for the properties held by these private partnerships, and, thus, no way to easily value Bill's IRA. The IRS may suspect Bill of lowering the valuation to reduce taxable distributions.

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What's Inside

Senior Ceiling

In 2017, the maximum Social Security benefit for a worker retiring at full retirement age (now 66) is $2,687 a month, or $32,244 a year.

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Trusted Advice

IRAs for 2016 and 2017

- For 2016 and 2017, total contributions to traditional and Roth IRAs cannot be more than $5,500, or $6,500 for those age 50 or older.
- IRA contributions can't exceed taxable compensation for the relevant year.
- Contributions to a traditional IRA are prohibited for those 70½ or older. Contributions to a Roth IRA are permitted, regardless of age.
- If married couples file a joint tax return, one spouse may be able to contribute to an IRA even without taxable compensation for the year. The amount of the couple's combined contributions can't exceed the taxable compensation reported on the joint return.

A similar situation may appear if Bill wants to convert his traditional IRA to a Roth IRA. Converting a traditional IRA with $500,000 in mutual funds to a Roth IRA will generate $500,000 of income to be taxed, but how much income will be generated when an IRA holding real estate assets is converted?

Cracking down

To prevent undervaluation that can lead to tax underpayments, the IRS is requiring more information from IRA custodians on Forms 5498 and 1099-R for 2015 and later years. On Form 5498, which is filed annually with information on IRA account value and whether a distribution is required, IRA custodians must reveal the presence of hard-to-value assets and the asset type. The same information is required on Form 1099-R, which reports the amount of any IRA distribution. (For Form 1099-R, this rule affects in-kind distributions of hard-to-value assets.)

With this information, the IRS will be able to focus on IRAs that hold illiquid assets, which are subject to RMDs. The agency can follow up to see if the reported valuation was arrived at fairly.

Impact on IRA owners

Individuals who want hard-to-value assets in their IRA, for their growth potential, should be vigilant about providing reliable valuations.

Example 2: Bill Carson's IRA holds $100,000 in liquid assets as well as private real estate investments. Bill's IRA custodian has listed Bill's cost—$400,000—as the value of the real estate.

This year, Bill will be 71, so the IRS Uniform Lifetime Table gives him a "distribution period" of 26.5 years. Using the historical $400,000 cost of the real estate, Bill would divide the total account value ($500,000) by 26.5 to get an RMD of $18,868.

Now, however, Bill's IRA custodian requires him to get a current appraisal of the real estate holdings in the IRA. Suppose the appraiser finds the real estate interests in Bill's IRA are worth $750,000. This would drive the account value up to $850,000, as reported on Form 5498, and the RMD to more than $32,000. If Bill withdraws less, he could owe a 50% penalty on the shortfall.

For IRA owners, finding an IRA custodian that will hold hard-to-value assets can be a challenge. Once that's accomplished, the next step may be discovering the custodian's valuation policy. A custodian could require an IRA owner to provide a valuation once per year, from an independent source. A valuation might come from the sponsor of the deal, from an executive of a private company with stock in the account, or a reputable third party. For real estate, an annual comparative market analysis might be required. ■

Did You Know?

About 84% of large employers will offer high-deductible health plans in 2017. Indeed, 35% of large employers will offer only high-deductible plans to their workforce. Some workers' deductibles will be offset by employers' contributions to health savings accounts: tax-free funds that workers can use to pay for out-of-pocket health care costs.

Source: wsj.com

The "Other" Exchange-Traded Funds

Exchange-traded funds (ETFs) have become popular in this century, due largely to relatively low expenses and tax efficiency. (See the July 2016 *CPA Client Bulletin* for more on ETFs.) As the name indicates, ETFs trade like stocks, on an exchange, as opposed to mutual funds, which typically are bought from and sold to the sponsoring company. Often, ETFs track a particular market index.

Less publicized these days are what might be considered the original exchange-traded funds, known as *closed-end funds*. Closed-end funds also issue a certain number of shares, which trade between investors on a stock exchange. Rather than mimic an index, closed-end funds usually are actively managed, in an effort to deliver superior returns to investors.

The case for closed-ends

Should investors put money into closed-end funds? Perhaps. Some closed-end funds have excellent long-term records, including some that specialize in a certain area, such as a single foreign country's stocks.

In addition, specific features of these funds might appeal to investors. For instance, closed-end funds frequently trade at a premium or a discount to net asset value (NAV).

Example 1: CEF closed-end fund holds stocks of various companies; the current market value of those shares is $100 million. Ten million shares of CEF are outstanding. Thus, the NAV of CEF is $10 per share ($100 million divided by 10 million).

Nevertheless, CEF now trades at $9.25 a share: a 7.5% discount to its NAV. Over the past year, CEF has sometimes traded at a larger discount, sometimes at a smaller discount, and sometimes even at a premium to its current NAV.

Among the universe of closed-end funds, it's typical for investors to see a range of premiums and discounts, which can change at any time. Some investors will study a desirable closed-end fund for some time, observing its discount/premium range. When the fund is nearest its widest discount to NAV, there may be a buying opportunity, and a chance to profit if the discount narrows, beyond the normal profit potential of investing in securities. There's also risk, if the discount should become even larger, in addition to the usual market risk that a share price might drop.

Using leverage

In addition, buying closed-end shares at a discount can raise the dividend yield to investors. If CEF holds companies with an average dividend yield of, say, 4%, and investors can buy at a 10% discount to NAV, the dividend yield would go up to 4.44%: an annualized 40 cents a share, on a $10 NAV, if CEF is purchased at $9 a share.

Some closed-end funds go even further to boost yields to investors. They use leverage to buy more shares, perhaps by borrowing money or issuing preferred shares or using other tactics. Closed-end bond funds may be likely to follow such a plan.

Example 2: LEV closed-end fund issues $100 million worth of common shares and leverages the fund by issuing $50 million of preferred shares, paying 3% to investors. Then, LEV uses the total $150 million raised to buy municipal bonds with an average yield of 5%.

The $150 million of municipal bonds will pay $7.5 million a year in interest at 5%. LEV will pay $1.5 million to its preferred shareholders: 3% of $50 million. That will leave $6 million ($7.5 million minus $1.5 million) for investors in the common shares. The latter investors will get a 6% return on their $100 million outlay, even though LEV holds bonds yielding 5%. Leverage can benefit investors, but such practices also can add to losses in a down market, so investors should proceed with care.

Information about these funds is available from the Closed-End Fund Association at cefa.com. ■

Profit-Sharing Plans for Your Small Business

Business owners who want to sponsor a retirement plan for employees (including owner-employees) have many options from which to choose. Knowing the basics can help entrepreneurs make an astute decision.

One choice is a profit-sharing plan. Despite its name, your company needn't tabulate its earnings every year and divide that amount among its workers. Instead, the term indicates a plan in which contributions to employees' retirement accounts are made by the employer. Therefore, a profit-sharing plan may help your company to attract, motivate, and retain valued employees. These plans are flexible, so employers can contribute more in good years and less (or nothing at all) when business is slow.

Considerable contributions

Profit-sharing plans may permit employers to make relatively large, tax-deductible contributions to employees' retirement funds. Employees won't owe income tax until the money is withdrawn; in the interim, any investment earnings can compound, untaxed.

In 2017, employer contributions can be up to 100% of compensation, with a ceiling of $54,000. Of those contributions, the company can deduct amounts up to 25% of total compensation for all participants.

A traditional profit sharing plan usually calls for prorata contributions to all covered employees' accounts.

Example 1: PSP Corp. makes a $6,000 contribution to an account for Al, who earns $30,000 (20% of pay), $10,000 to Barb, who earns $50,000, $20,000 for Chet, who earns $100,000, and $50,000 for Doris, the company owner who earns $250,000.

Profit sharing plans must have a set formula for determining how the contributions are allocated among

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plan participants, but they needn't be traditional prorata plans, as illustrated in example 1. Instead, profit-sharing plans may be structured to put a greater percentage of compensation in the accounts of certain employees. Such a plan might result in a contribution of around $8,000 or even $2,500 to the account for Barb, earning $50,000, while Doris, earning $250,000, still gets $50,000 contributed to her account. These sophisticated profit-sharing plans must be constructed with care, to comply with federal rules; our office can help if you're interested in this type of arrangement.

Nuts and bolts

Participation in a profit-sharing plan typically must be offered to all employees age 21 or older who worked at least 1,000 hours in a previous year. Employer contributions may vest over time, according to a plan's specific terms. Annual filing of IRS Form 5500 is required. Withdrawals generally will be permitted at retirement, plan termination, and perhaps at other times, such as after age 59½. Distributions will be taxed. A profit-sharing plan may permit loans and hardship withdrawals, but withdrawals before age 59½ may trigger income tax plus an additional tax of 10%. ■

TAX CALENDAR

JANUARY 2017

January 17

Individuals. Make a payment of your estimated tax for 2016 if you did not pay your income tax for the year through withholding (or did not pay enough in tax that way). Use Form 1040-ES. This is the final installment date for 2016 estimated tax. However, you don't have to make this payment if you file your 2015 return and pay any tax due by January 31, 2017.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in December 2016, if the monthly rule applies.

January 31

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2016. Payments that are covered include: (1) compensation for workers who are not considered employees, (2) dividends and other corporate distributions, (3) interest, (4) rents, (5) royalties, (6) profit-sharing distributions, (7) retirement plan distributions, (8) original issue discounts, (9) prizes and awards, (10) medical and health care payments, (11) debt cancellations (treated as payment to debtor), (12) payments of Indian gaming profits to tribal members, and (13) cash payments over $10,000. There are different forms for different types of payments.

Employers. Give your employees their copies of Form W-2 for 2016.

For nonpayroll taxes, file Form 945 to report income tax withheld for 2016 on all nonpayroll items, such as back-up withholding and withholding on pensions, annuities, and IRAs.

For Social Security, Medicare, and withheld income tax, file Form 941 for the fourth quarter of 2016. Deposit or pay any undeposited tax. If your tax liability is less than $2,500, you can pay it with the return. If you deposited the tax for the quarter in full and on time, you have until February 10 to file the return.

For federal unemployment tax, file Form 940 (or 940-EZ) for 2016. If your undeposited tax is $500 or less, you can either pay it with your return or deposit it. If it is more than $500, you must deposit it. However, if you already deposited the tax for the year in full and on time, you have until February 10 to file the return.

FEBRUARY 2017

February 15

All businesses. Give annual information statements (Forms 1099) to recipients of certain payments you made during 2016. Payments that are covered include: (1) amounts paid in real estate transactions; (2) amounts paid in broker and barter exchange transactions; and (3) payments to attorneys.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in January if the monthly rule applies.

Individuals. If you claimed exemption from income tax withholding last year on the Form W-4 you gave your employer, you must file a new Form W-4 to continue your exemption for another year.

February 16

Employers. Begin withholding income tax from the pay of any employee who claimed exemption from withholding in 2016, but did not give you a new Form W-4 to continue the exemption for 2017.

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